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THE SUPREME COURT OF INDIANA AND FEDERAL TAXATION OF STATE INSTRUMENTALITIES

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In *Burnett v. Coronado Oil and Gas Co.*[1] the Supreme Court of the United States ruled that a lessee's income from the sale of oil and gas produced under lease of State School lands is not taxable by the National government because such a lease is a governmental instrumentality of a state. Only recently, the Supreme Court held that motorcycles sold to a municipality for use in its police service may not be taxed by the National government.[1a] Both of these cases involve the question of the constitutional right of the National government to tax the governmental instrumentalities of the States. It is perhaps a matter of common knowledge that the Supreme Court long ago denied this right, when, in *Collector v. Day*,[2] it was held that the National government may not rightfully tax the compensation of State judges. The Supreme Court, in subsequent cases, has repeatedly reaffirmed the tax-immunity of the governmental agencies of a State.[3]

It is somewhat interesting to note, however, that this now well-established and familiar principle of constitutional law, which concerns not only a question of taxation but also the problem of the general relations between the State and National governments, did not originate with *Collector v. Day*,[4] as may be commonly supposed, but, on the contrary, was first declared several years earlier by the Supreme Court of Indiana in *Warren v. Paul*.[5]

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1 (1932) 52 Sup. Ct. 443.

1a *Indian Motorcycle Company v. United States* (1931), 283 U. S. 570, 75 L. Ed. 1277.

2 (1870), 11 Wallace 113, 20 L. Ed. 122.

3 *United States v. Railroad* (1872), 17 Wallace 322, 21 L. Ed. 597; *Ambrosini v. United States* (1902), 187 U. S. 1, 47 L. Ed. 304; *Pollock v. Farmers Loan and Trust Company* (1895), 157 U. S. 429, 39 L. Ed. 759; *Willcuts v. Bunn* (1931), 283 U. S. 570, 75 L. Ed. 1277.

4 *Supra*, note 2.

5 (1864), 22 Ind. 276.

Before discussing this contribution of the Indiana court to the development of the rule of law set forth above, it is necessary that we first consider the events which led to the formulation of such a rule.

In 1819, the Supreme Court of the United States, in *McCulloch v. Maryland,*[6] laid down what has since become a well-established rule of constitutional law, *viz.*, that the several States may not tax the means or instrumentalities employed by the Federal government to carry into effective operation its essential governmental functions. Congress, on April 10, 1816, had chartered the Second Bank of the United States. On February 11, 1818, the General Assembly of Maryland passed an act which imposed a heavy tax upon notes issued by the Baltimore branch of the United States Bank. As a result of the refusal of the branch bank to pay this tax, the case of *McCulloch v. Maryland* came on writ of error to the Supreme Court, with the Bank contesting the validity of the Maryland tax law and the defendant, "a sovereign state," denying the authority of Congress to create a national bank.[7]

After having decided that Congress has the implied power to incorporate a national bank,[8] Chief Justice Marshall, in delivering the opinion of the Court, turned to a consideration of whether the State of Maryland might constitutionally impose a tax upon a bank.[9]

The Chief Justice first pointed out that the power of taxation had been retained by the States when the Constitution was formed; that the power of the States to tax "is not abridged by the grant of a similar power to the government of the Union;"[10] that the power of taxation is to be exercised concurrently by the two governments. On the other hand, the National Constitution and laws are supreme; the States are controlled by them. Therefore, when any conflict arises between the National government and the States, "that authority which is supreme must control, not yield to that over which it is supreme."[11]

In this case, Congress had created a bank; the State of Maryland was attempting to tax that bank. So Marshall said:

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[6] 4 Wheat, 316, 4 L. Ed. 579.

[7] *Ib.* 316-17, 4 L. Ed. at 579-80.

[8] *Ib.* 400-24, 4 L. Ed. at 600-606.

[9] *Ib.* 424-435, 4 L. Ed. at 606-609.

[10] *Ib.* 425, 4 L. Ed. at 606.

[11] *Ib.* 426, 4 L. Ed. at 606.

"All subjects over which the sovereign power of a state extends, are objects of taxation; but those over which it does not extend, are, upon the soundest principles, exempt from taxation."[12]

And Marshall went on to emphasize that the sovereignty of a State does not "extend to those means which are employed by Congress to carry into execution powers conferred on that body by the people of the United States."[13] Because, said Marshall, "the power to tax involves the power to destroy.[14] * * * If the states may tax one instrument, employed by the government in the exercise of its powers, * * * they may tax all the means employed by the government, to an excess which would defeat all the ends of government. This was not intended by the American people. They did not design to make their government dependent on the states."[15]

Thus the attempt of the State of Maryland to tax the operations of a branch of the United States bank failed, and the important rule was established, and has since been closely followed,[16] that the States may not tax the governmental instrumentalities of the Federal government.

Marshall's opinion in *McCulloch v. Maryland*,[17] a classic exposition of Federal supremacy, dealt a great blow to "state sovereignty"; the foundation was here laid for a notable expansion of Federal power. This case marks the beginning of a chain of decisions which slowly but none the less surely has closed in around and restricted the taxing power of the States. With the elapse of time, the category of Federal instrumentalities has increased steadily while billions of dollars of taxable wealth, wrapped in the mantle of National sovereignty, have been removed from the sphere of State taxation. *McCulloch v. Maryland* furnished new impetus toward increasing the power and prestige of the National government. The "co-sovereign states" in our federal system must henceforth stand aside when

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12 *Ib.* 429, 4 L. Ed. at 607.

13 *Ib.* 429, 4 L. Ed. at 607.

14 *Ib.* 431, 4 L. Ed. at 607.

15 *Ib.* 432, 4 L. Ed. at 608.

16 *Weston v. Charleston* (1829), 2 Pet. 449, 7 L. Ed. 481; *Dobbins v. Commissioners of Erie County* (1842), 16 Pet. 435, 10 L. Ed. 1022; *Bank of Commerce v. New York* (1862), 2 Black 620, 17 L. Ed. 793; *California v. Central Pac. Rd. Co.* (1887), 127 U. S. 1, 32 L. Ed. 150; *Long v. Rockwood* (1928), 277 U. S. 142, 72 L. Ed. 824; *Home Savings Bank v. Des Moines* (1907), 205 U. S. 503, 51 L. Ed. 901; *Panhandle Oil Co. v. Mississippi* (1928), 277 U. S. 218, 72 L. Ed. 857.

17 *Supra*, note 6.

the "supreme authority" of the National government is endangered.

Then came the Supreme Court of Indiana to place a restraint on the sweeping march of the National government to power, at the same time restoring the States, in some degree at least, to their rightful position in our federal system. Because, after fifty years of growing National supremacy, the Indiana court asserted that, if the States may not tax the instrumentalities of the National government, then neither may the National government tax the instrumentalities of the States.[18]

In *Warren v. Paul*,[19] the Court below had dismissed a suit because certain State judicial process was not properly stamped in accordance with the provisions of the National Revenue Act of June 30, 1864.[20] In order to determine the propriety of the lower court's action, the Court apparently resolved to face squarely the question whether Congress might rightfully tax the legal proceedings in State courts. Mr. Justice Perkins, in delivering the opinion of the Court, found that there were no time-worn precedents to guide him. Just as Chief Justice Marshall had entered a new, unbroken field fifty years earlier in determining the tax-exemption of Federal instrumentalities, so we find Justice Perkins in a somewhat similar situation when faced with the task of determining the taxability of State instrumentalities. He first turned, therefore, to a consideration of certain provisions of the Federal Constitution, pointing out that the Tenth Amendment clearly states that the powers of Congress are delegated; that the powers not so delegated, nor prohibited to the States, "are reserved to the States respectively, or to the people."[21] In view of this, it is clear that the delegated powers of the United States and the reserved powers of the States are recognized in the Constitution. This is evidence, reasoned Justice Perkins, that the State governments *are* to exist concurrently with the National government; that the States have certain independent powers over which the National government has no control.[22]

Having established the fact that certain State powers are independent of National control, the Court proceeded to consider the general power of Congress to tax. Justice Perkins

[18] *Supra*, note 5.
[19] *Ib.*
[20] 13 Stat. 218, 301.
[21] *Supra*, note 17 at 277.
[22] *Ib.*

suggested that Congress has no power to require stamps on legal documents, this being "a tax on the right to justice."[23] Conceding, however, that Congress may tax legal proceedings, Justice Perkins asserted that such a tax cannot be imposed on the judicial process of State courts. He says that it is manifest all the way through the Constitution that the States are to have their own respective judicial tribunals. This being so, these tribunals must not be hindered or burdened by Congress, because this would be "imcompatible with their free existence."[24] Justice Perkins reasons that inasmuch as the States may not by taxation interfere with Federal instrumentalities, so "the argument applies with full force to the exemption of State governments from Federal legislative interference * * * it seems to result as necessary to harmony of operation between the Federal and State governments,"[25] that neither be given the right either directly or indirectly to "annihilate" by taxation the governmental functions of the other.

The Court also mentioned that under the Articles of Confederation, Congress might legislate upon the States, but not upon citizens; that one of the most important changes which the Constitution effected was that, henceforth citizens, not the States, might be legislated upon by Congress. Therefore, the attempt of Congress to impose a stamp tax which operates upon State judicial process is not a valid exercise of the power to tax and the Court concluded that such a tax is unconstitutional and void.[26]

Several years later, the Supreme Court gave its approval to Justice Perkins proposition, when in *Collector v. Day*,[27] the question was presented whether the Federal government may tax the salaries of State judges. In deciding that such a tax is unconstitutional and void, the Court admitted that the Constitution does not expressly prohibit Congress from levying such a tax, but that the prohibition is a necessary implication from the dual nature of our federal system; that "in respect to the reserved powers, the State is as sovereign and independent as

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[23] *Ib.* 278. It is interesting that in determining whether Congress may properly impose a stamp tax, there being no precedents, Justice Perkins consults Adam Smith, Wealth of Nations, 371, and John Stuart Mill, Political Economy, II, 460-65.

[24] *Ib.* 279.

[25] *Ib.* 280.

[26] *Ib.* 281.

[27] *Supra*, note 2.

the general government. And if the means and instrumentalities employed by that government to carry into operation the powers granted to it are necessarily, and, for the sake of self-preservation, exempt from taxation by the States, why are not those of the States depending upon their reserved powers, for like reasons, equally exempt from Federal taxation? Their unimpaired existence in the one case is as essential as in the other."[28]

In view of the fact that at the present time there is a tendency on the part of both the courts[29] and text-writers[30] to recognize *Collector v. Day* as the earliest land-mark in this particular field of constitutional law, the writer suggests that, on the contrary, such recognition really belongs to *Warren v. Paul.*[31] The fact is sometimes overlooked that the courts of the several States, as well as the Supreme Court of the United States, may have played an important part in the formulation of American constitutional law.

And now, in conclusion, we may sum up briefly the reasons why *Warren v. Paul* is worthy of attention. In the first place, Justice Perkins was the first to assert the proposition that the National government may not tax the governmental agencies of the States. Although he based this proposition on the analogy afforded by *McCulloch v. Maryland,*[32] when he said that if Federal instrumentalities are exempt from State taxation, "the argument applies with full force to the exemption of State governments from Federal legislative interference," it is interesting to note that Marshall did not admit the reciprocity of this doctrine. In *McCulloch v. Maryland,* he said:

"It has . . . been insisted, that, as the power of taxation in the general and state governments is acknowledged to be concurrent, every argument which would sustain the right of the general government to tax banks chartered by the states, will equally sustain the right of the states to tax banks chartered by the general government. But the two cases are not on the same reason . . . The difference is that which always exists, and always must exist, between the action of the whole on a part, and the action of a part on the whole—between the laws of a government declared

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28 *Ib.*

29 *Supra,* note 3.

30 Thomas M. Colley, A Treatise on Constitution Limitations (Boston, 1927), II, 996; Charles K. Burdick, Law of the American Constitution, (New York, 1926), 197.

31 *Supra,* note 5.

32 *Supra,* note 6.

to be supreme, and those of a government which, when in opposition to those laws, is not supreme."[33]

Yet, in spite of Marshall's disapproval, we find the view taken by Justice Perkins that those agencies through which either the Federal or State governments exercise their sovereign powers are immune from the taxing power of the other, has been repeatedly reaffirmed by the Supreme Court,[34] and the case of *McCulloch v. Maryland* has been frequently cited as an authority for such a view.[35]

In the second place, while there is no direct evidence that the decision of the Indiana court in *Warren v. Paul* influenced the opinion of Justice Nelson in *Collector v. Day*, it may have done so indirectly. The Supreme Court of Michigan, in *Fifield v. Close*,[36] followed the precedent established by the Indiana court in upholding the validity of an unstamped summons issued by a justice of the peace. The Michigan court reiterated the contention of Justice Perkins that Congress is impliedly prohibited from taxing any of the functions which are under State control.[37] In *Jones v. Keep*,[38] the Supreme Court of Wisconsin also followed the trail marked out by the Indiana court. In *Collector v. Day*, we find Justice Nelson advancing an argument very similar to that of Justice Perkins, although neither counsel nor Justice Nelson made any reference to *Warren v. Paul*, nor to the decisions of the Michigan and Wisconsin courts.

That Congress may have been influenced somewhat by the Indiana decision is seen in the fact that the stamp tax on judicial process was repealed in 1867,[39] and never since has such a tax been attempted by Congress. It is also worthy of note that in the same act, although several years before *Collector v. Day*, Congress inserted a clause which provided "that all official instruments, documents, and papers issued * * * by the officers of any State, county, town, or other municipal coporation shall be * * * exempt from taxation."[40]

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[33] Ib. 435-36.

[34] *Supra*, note 3.

[35] *Ib.*

[36] (1867), 15 Mich. 505.

[37] *Ib.* 506-07.

[38] (1865), 19 Wis. 390.

[39] 14 Stat. 475.

[40] This clause was also inserted in the Revenue Act of July 13, 1866, 14 Stat. 141.

It is not clear just how Justice Perkins happened to conceive this reciprocal application of the *McCulloch v. Maryland* rule, but whatever may have been his motives, he first declared a rule of constitutional law which remains today a growing and far-reaching principle, *viz.*, that the National government may not tax the governmental instrumentalities of the States.[41]

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[41] In *South Carolina v. U. S.* (1905), 199 U. S. 437, 50 L. Ed. 261, the Supreme Court held that the National government may tax the proprietary, non-governmental functions of the States.